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In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 218

LEONARD HYATT AND MAUDIE HYATT, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 116–164) [1] are not officially reported. The *per curiam* opinion of the Court of Appeals (Pet. 13) is reported at 325 F. 2d 715.

JURISDICTION

The judgment of the Court of Appeals was entered on December 18, 1963. (Pet. 14.) A petition for rehearing was denied on January 31, 1964. (Pet. 15.) The time for filing a petition for a writ of certiorari was extended by an order of Mr. Justic Black to and including June 29, 1964, and the petition was filed on

[1] "R." references are to the record in the Court of Appeals.

June 26, 1964. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

Whether sums received by the taxpayer upon the transfer of his rights under an insurance company management contract are taxable as ordinary income, as the two courts below have held, or as capital gains.

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 117 [As amended by Sec. 150(a)(1), Revenue Act of 1942, c. 619, 56 Stat. 798; Sec. 210(a), Revenue Act of 1950, c. 994, 64 Stat. 906; and Sec. 322(c)(2), Revenue Act of 1951, c. 521, 65 Stat. 452]. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(b), or real property used in his trade or business;

(C) a copyright; a literary, musical, or

artistic composition; or similar property; held by—

(i) a taxpayer, whose personal efforts created such property, or

(ii) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property; or

(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

* * * * *

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income;

* * * * *

[26 U.S.C. (1952 ed.) Sec. 117.]

STATEMENT

The facts found by the Tax Court (R. 119–120, 145–148), insofar as they relate to the issue raised by the petition for certiorari, may be summarized as follows:

Leonard Hyatt, the taxpayer,[1] and the United Security Assurance Company, a Texas state-wide mutual

[1] Maudie Hyatt is a party to this action solely because of the filing of joint returns during the years in issue.

assessment life insurance company, executed a general agency contract on March 8, 1949. By this agreement, taxpayer was granted the sole and exclusive agency for United Security. (R. 145.)

In Texas, state-wide mutual assessment life insurance companies are nonprofit corporations customarily financed and operated by an individual under a management or general agency contract with the compay. Such agency contracts usually provide, in accordance with Texas law, that 60% of gross premiums must be set aside in a mortuary fund for the payment of claims, and that 40% of the premiums is available to the owner of the contract to pay expenses, with any excess accruing to the general agent's account. General agencies under management contracts are regarded as separate businesses in Texas, distinct from that of the company itself, and are frequently bought and sold. (R. 120.)

The contract involved here required the taxpayer to (R. 145)—

> Furnish all necessary office space, office furniture, fixtures, supplies, records and employees to properly operate the business of the Company and to pay all expenses in connection with the operation of the business of the Company except that all properly approved claims under certificates or policies and all attorney's fees and necessary expenses arising out of the defense, settlement or payment of contested claims shall be paid out of the mortuary fund * * *

It provided further that (R. 145):

> Upon the termination of this contract all such office furniture, fixtures, supplies and records shall remain the sole and individual property of the said Hyatt and that he shall be compensated by the Company for all good will of the Company and the value of this contract in such amount as may be determined by the Board of Directors.

The taxpayer was to be remunerated from whatever amount remained in the expense fund (that is, the 40% of gross premiums) after the expenses of the business had been paid. In addition, his rights under the contract were assignable. (R. 145–146.)

When the agreement was executed, United Security had no assets and no business. The taxpayer furnished the necessary finances, the office, furniture, fixtures, employees, and personal services necessary to build up the business. (R. 146.)

On November 8, 1952, United Security and Western American Life Insurance Company of Austin, Texas, agreed that the latter would reinsure all of the United Security insurance then in force except its "Group S" business. The consideration to be paid United Security was $72,375. The board of directors of United Security, with the taxpayer abstaining, authorized the company to enter into an agreement with the taxpayer under which the consideration to be received from Western American would be assigned to the taxpayer in consideration for his transfer to United Security of his rights in the general agency contract and the insurance busi-

ness covered thereby, except the "Group S" business. This was accomplished on November 8, 1952, by a contract providing in pertinent part (R. 147):

> Whereas, Hyatt, by virtue of a contract or agreement with United dated the 8th day of March, 1949, is the General Agent of United and as such is entitled to a substantial income,
>
> Now, Therefore, in consideration of United assigning to Hyatt simultaneously with the sale provided for in this agreement, all of its rights and interest to receive payment from Western as follows:
>
> (a) Seventy-two Thousand Three Hundred Seventy-five Dollars ($72,375.00) within five (5) days after the approval of a contract of reinsurance as provided in Paragraph 1 of an agreement dated the 24th day of November, 1952, between Western American Life Insurance Company and United Security Assurance Company;
>
> Hyatt hereby sells, transfers, conveys and assigns to United all of his rights, including the income to which he is entitled in and to the General Agency Contract.

The reinsurance agreement between the two companies was ratified by the policyholders of United Security on November 24, 1952. The Board of Insurance Commissioners of Texas approved the reinsurance agreement on November 26, 1952. On December 3, 1952, Western American issued reinsurance certificates to the policyholders of United Security. (R. 147–148.)

The taxpayer received $20,000 in 1952 on account of this transaction; he received the balance of $52,375

in 1954. In his income tax returns for those years he reported these amounts as long-term capital gains. The Commissioner, however, determined that these sums were taxable as ordinary income. The Tax Court and the Court of Appeals agreed. (R. 148, 151; Pet. 13.)

ARGUMENT

The *per curiam* decision of the Fifth Circuit in this case is correct. While it is true that there is some inconsistency, at least of language, in decisions of the Fifth Circuit,[3] there is no conflict among the circuits and no occasion for review by this Court.

1. This case involves the termination of management and agency rights under a contract which the taxpayer had with a mutual insurance company. He had previously been exercising these rights, and thus had been earning compensation for services rendered to the company—compensation taxable to him at ordinary income rates. (R. 145–146.) Under the termination agreement, he was paid, at least largely, for what he had already earned, but not yet received, for his services. The agreement recites that the taxpayer "is entitled to a substantial income", and it concludes (R. 147):

> Hyatt hereby sells, transfers, conveys and assigns to United all of his rights, including the income to which he is entitled in and to the General Agency Contract.

[3] Compare *Nelson Weaver Realty Co.* v. *Commissioner*, 307 F. 2d 897, and *United States* v. *Dresser Industries, Inc.*, 324 F. 2d 56, with *United States* v. *Eidson*, 310 F. 2d 111, on rehearing, 312 F. 2d 744; *Bisbee-Baldwin Corp.* v. *Tomlinson*, 320 F. 2d 929; and *United States* v. *Woolsey*, 326 F. 2d 287.

It appears in addition that there was no sale of physical assets. As noted above, the original contract provided (R. 145):

> Upon the termination of this contract all such office furniture, fixtures, supplies and records shall remain the sole and individual property of the said Hyatt * * *.

Even if it could be said on this record that a determinable portion of the payment made upon termination reflected a commutation of earnings anticipated as a result of future, rather than past, sales of insurance, there would, in our view, be no sound basis for capital gains treatment. To be sure, taxpayer's interest in his contract was a species of property. But, as this Court stated in *Commissioner* v. *Gillette Motor Co.*, 364 U.S. 130, 134:

> While a capital asset is defined in § 117(a)(1) as "property held by the taxpayer," it is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset. This Court has long held that the term "capital asset" is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year.

See, also, *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260; *Corn Products Co.* v. *Commissioner*, 350 U.S. 46; *Hort* v. *Commissioner*, 313 U.S. 28.

The mere fact of a sale or exchange does not operate to convert ordinary income into capital gain.[4] Rather, it is the nature of the underlying right assigned which determines precisely how the sales proceeds are taxable. If the right assigned is merely the opportunity afforded by contract to render services and receive payment therefor, the amount received in consideration is not, in any meaningful sense, a return of capital plus appreciation; rather, it is a present substitute for the ordinary income which could have been earned had the contract been performed. Here the termination agreement itself recognized that the taxpayer was being paid for his income rights. (R. 147.) Such proceeds are taxable as ordinary income and not as capital gain. *Holt* v. *Commissioner*, 303 F. 2d 687 (C.A. 9th); *Wiseman* v. *Halliburton Oil Well Cementing Co.*, 301 F. 2d 654 (C.A. 10th); *Commissioner* v. *Ferrer*, 304 F. 2d 125, 133–134 (C.A. 2d); *Appalachian Electric Power Co.* v. *United States*, 158 F. Supp. 138 (Ct. Cl.).[5] In sum, what this Court said in *Commissioner* v. *P. G. Lake, Inc.*, *supra* (p. 266), clearly describes the present case:

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[4] We pass the question whether the termination in this case was a sale or exchange rather than a mere extinguishment of rights by cancellation.

[5] If, however, income-producing property (or an interest therein) is conveyed, the consideration received is properly reported by the taxpayer as capital gain. *Commissioner* v. *Ferrer*, *supra*, pp. 131–133; *Commissioner* v. *Golonsky*, 200 F. 2d 72 (C.A. 3d), certiorari denied, 345 U.S. 939; *Commissioner* v. *Ray*, 210 F. 2d 390 (C.A. 5th), certiorari denied, 348 U.S. 829; *Metropolitan Building Co.* v. *Commissioner*, 282 F. 2d 592 (C.A. 9th).

> The substance of what was received was the present value of income which the recipient would otherwise obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property.

2. The inter-circuit conflict alleged by the taxpayer (Pet. 7) does not in fact exist. In *Commissioner* v. *Ferrer, supra,* the taxpayer conveyed a bundle of rights consisting in part of interests in income-producing property (pp. 131–133) and in part of a mere contract right to share in future profits of a moving-picture venture (pp. 133–134); he was only permitted to report that part of the proceeds attributable to the former as capital gain. In *McCullough* v. *Commissioner,* 326 F. 2d 199 (C.A. 9th),* the court allowed the taxpayer to report his profit as capital gain where substantial interests in patents were transferred by him during the taxable year in question. In doing so, it drew a distinction between a transfer of contractual rights representing capital assets and those representing the right to receive future income (326 F. 2d at 203). It is perfectly true, as petitioner states (Pet. 9), that a panel of the Fifth Circuit has questioned the broad interpretations which have been given this Court's opinion in the *P. G. Lake* case. *United States* v. *Dresser Industries, Inc.,* 324 F. 2d 56. But in the *Dresser* case itself the court does construe the facts (324 F. 2d at 59) as disclosing a transfer of

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*The taxpayer (Pet. 7) alleges a conflict with the Ninth Circuit specifically. But in addition to *Holt* v. *Commissioner, supra,* see *Roth* v. *Commissioner,* 321 F. 2d 607 (C.A. 9th).

income-producing property rather than as a mere transfer of a contractual right to future ordinary income.

CONCLUSION

It is respectfully submitted that the petition for a writ of certiorari should be denied.

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